

THE SUBPART F “LOOK-THROUGH” RULE OF SECTION 954(c)(6):

TAX POLICY CONSIDERATIONS

David G. Noren

April 2012

I. INTRODUCTION AND SUMMARY

The United States taxes the worldwide income of U.S.-based companies, but the U.S. tax on the active trade or business income of their foreign subsidiaries—known as controlled foreign corporations, or CFCs—generally is deferred until that income is distributed to the U.S. parent company as a dividend. The Subpart F rules are an exception to this deferral regime and generally are intended to tax currently income that is passive in nature, rather than active trade or business earnings. Prior to 2006, Subpart F income included active business earnings that were redeployed from a subsidiary that earned the income in one country to a subsidiary in another country to expand in the other country or make an acquisition, even though these earnings would not otherwise be considered “passive” in nature.

In 2006, the Congress enacted section 954(c)(6) (the “Look-Through Rule”). The Look-Through Rule allows U.S.-based companies to redeploy their active foreign earnings outside the United States as their business needs may dictate without subjecting the earnings to current U.S. taxation under Subpart F.¹ This rule only applies, however, to the extent that such payments are attributable or properly allocable to active, non-Subpart-F income of the related CFC. Regulatory authority is provided, and has been exercised by the IRS, to prescribe such regulations as may be necessary to prevent the abuse of the purposes of the Look-Through Rule.² The Look-Through Rule is temporary and has been included in the last two business tax “extenders” packages. The provision expires under present law for taxable years beginning after the end of 2011.³

Partner, McDermott Will & Emery LLP. The views expressed in this paper are the author’s own and do not necessarily reflect the views of McDermott or its clients.

¹ The Look-Through Rule accomplishes this result by generally providing that dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC are not subject to U.S. tax on a current basis under Subpart F.

² This authority has been exercised thus far through the issuance of a notice, with regulations to follow. *See* Notice 2007-9, sec. 7.

³ As originally enacted, the Look-Through Rule was set to expire at the end of 2008. In October 2008, the Congress extended the provision by an additional year, through the end of 2009, as part of the extenders package in the Emergency Economic Stabilization Act of 2008. The provision then expired at the end of 2009 but was renewed in December 2010 as part of the extenders package in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, with retroactive effect to the beginning of 2010 and extending through 2011. The Obama administration’s FY 2013 budget proposal would extend the Look-Through Rule through 2013.

This paper examines the tax policy rationale for the Look-Through Rule and describes the rule's impact on some common business structures and decisions of U.S.-based multinational enterprises. The paper also explores the effect of the Look-Through Rule on the competitiveness of U.S.-based multinationals with their foreign rivals, as well as the broader (but related) question of the rule's impact on the competitiveness of the U.S. economy in the world. As explained in detail below, the Look-Through Rule has significant potential to promote competitiveness by removing barriers to the efficient and flexible structuring of business operations and the deployment of active foreign earnings within U.S.-based multinational groups. The Look-Through Rule is an important pro-competitiveness measure under the present-law worldwide system with deferral, and the provision would take on even greater importance as a key structural feature of the international tax rules if the United States were to adopt a territorial dividend exemption system.

This paper also considers technical issues relating to preventing the abuse of the Look-Through Rule to achieve unintended and inappropriate tax benefits. As discussed below, potential abuses of the provision appear to be fairly narrow. In addition, the Look-Through Rule provides Treasury and the Service ample authority to address any future abuses that may come to light, and there is every reason to expect that this authority will be exercised energetically in appropriate circumstances.

On balance, making the Look-Through Rule permanent or enacting a long-term extension of the rule would do a great deal to promote the efficiency and competitiveness of U.S.-based companies that operate globally, while posing no significant threat of harm in the form of opportunities for inappropriate tax-avoidance behavior or incentives to shift business investment abroad.

II. LEGISLATIVE HISTORY AND TAX POLICY RATIONALE

A. Legislative History

In 2002, 2003, and 2004, versions of the Look-Through Rule appeared in several of the international tax bills that eventually culminated in the American Jobs Creation Act of 2004 ("AJCA").⁴ These provisions were substantially similar to the Look-Through Rule as it was eventually enacted in 2006, with the most notable difference being that the earlier provisions all would have been permanent, as opposed to temporary. The earlier look-through provisions enjoyed considerable bipartisan support as AJCA worked its way through the Congress, were reported favorably by both the Ways and Means Committee and the Finance Committee, and were approved in floor votes in both the House and the Senate. However, the provision was removed from the AJCA conference agreement at the very end of conference negotiations, reportedly due to overall revenue considerations, as opposed to any substantive concern about the provision.

⁴ See H.R. 5095, 107th Cong., 2d Sess. (2002), sec. 302; H.R. 2896, 108th Cong., 1st Sess. (2003), sec. 1103; S. 1637, 108th Cong., 1st Sess. (2003), sec. 222; H.R. 4520, 108th Cong., 2d Sess. (2004), sec. 311.

The legislative history from 2003 and 2004 indicates the Congress's conclusion that the U.S. international tax rules and, in particular, the anti-deferral rules of Subpart F, unduly interfered with business decisions regarding the deployment of active foreign earnings within a U.S.-based multinational group.⁵ In addition, the Senate legislative history notes that the tax cost imposed by prior-law Subpart F upon the movement of capital often could be avoided by taxpayers anyway (alluding to common planning under the check-the-box entity classification regulations), and implies that the results achieved through such planning are appropriate and should be made more widely and readily available to taxpayers.⁶ The House legislative history emphasizes the competitiveness concerns raised by prior law's restrictions on the redeployment of funds, noting that most foreign-based multinationals do not labor under such restrictive regimes and thus enjoy greater flexibility in structuring and funding their foreign investments.⁷

After almost four years of Congressional consideration and near-enactment in 2004, the Look-Through Rule was eventually enacted in May 2006, as part of the Tax Increase Prevention and Reconciliation Act of 2005⁸ ("TIPRA"). The Ways and Means Committee report and the Joint Committee staff's Bluebook explanation of the Look-Through Rule as enacted include the same policy discussion that was included in the House legislative history described and quoted above.⁹

The legislative history thus makes it clear that the Congress enacted the Look-Through Rule in order to remove impediments to efficient business decision-making concerning the redeployment of active foreign earnings within a U.S.-based multinational group, in part due to concerns that these impediments were placing U.S.-based multinationals at a competitive disadvantage relative to foreign-based multinationals. The legislative history does not explain why the provision was enacted on a merely temporary basis. However, the use of the same explanatory language to describe both the earlier permanent versions of the provision and the eventually enacted

⁵ See, e.g., S. Rep. 108-192, 39 ("The Committee believes that present law unduly restricts the ability of U.S.-based multinational corporations to move their active foreign earnings from one controlled foreign corporation to another.").

⁶ See S. Rep. 108-192, 39 ("In many cases, taxpayers are able to circumvent these restrictions as a practical matter, although at additional transaction cost. The Committee believes that taxpayers should be given greater flexibility to move non-Subpart-F earnings among controlled foreign corporations as business needs may dictate.").

⁷ See H.R. Rep. 108-548, Part 1, 202-03 ("Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States."); H.R. Rep. 108-393, 102 (including similar language).

⁸ Although the bill passed in 2006, it was enacted pursuant to the FY 2005 budget reconciliation instructions.

⁹ See H.R. Rep. 109-304, 45 (including the same "Reasons for Change" as H.R. Rep. 108-548, quoted above at note 7); JCS-1-07, 267 (same).

temporary version strongly indicates that revenue considerations, as opposed to any doubt about the provision's policy merits, caused the Congress to enact the provision on a temporary basis.

The Congress revisited the Look-Through Rule later in 2006 and again in 2007, making certain technical corrections to the provision in connection with the Tax Relief and Health Care Act of 2006 and the Tax Technical Corrections Act of 2007, as described below.

In addition, as noted above, in October 2008 the Congress extended the provision by an additional year, through the end of 2009, as part of the tax extenders package in the Emergency Economic Stabilization Act of 2008. Then, after allowing the provision to expire at the end of 2009, the Congress in December 2010 extended the provision retroactively to the beginning of 2010 and through the end of 2011, as part of the extenders package in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. The Obama administration's FY 2013 budget proposal, released February 13, 2012, would extend the Look-Through Rule through 2013.

B. Tax Policy Rationale

1. Remove Obstacles to the Foreign-to-Foreign Redeployment of Active Foreign Business Income

As the legislative history indicates, the fundamental tax policy rationale for the Look-Through Rule is to ensure that the U.S. tax system does not unduly interfere with the ability of U.S.-based businesses to redeploy their active, non-Subpart-F foreign earnings abroad as their business needs may dictate. Provided that the earnings represent active, non-Subpart-F business income, and thus are subject to deferral of U.S. tax when earned by the group, no good tax policy purpose is served by terminating deferral and thus subjecting the earnings to U.S. tax merely because the group moves the earnings of one CFC to a different CFC, often in another country, based on the two CFCs' relative business needs.

The Look-Through Rule thus addresses a specific problem that arose under prior law. Prior-law Subpart F generally lumped together truly passive flows of income into the group (e.g., interest received by a subsidiary on a portfolio securities investment) with redeployments of active earnings within the group (e.g., an intercompany dividend of earnings from a CFC in a mature market to a CFC in need of funding in a start-up market). The core concern of Subpart F is that truly passive flows might be placed in low-tax jurisdictions for tax reasons. The latter situation, in which active earnings are redeployed from one active business to another active business based on business needs, falls outside this core concern, thus rendering the prior-law rules overbroad in this respect. Although the "same-country" rules of section 954(c)(3) remedied this over-breadth to some extent, these rules are of course fairly limited in their scope and effect, as business needs frequently call for the redeployment of active foreign earnings from one foreign country to another.¹⁰

¹⁰ It is worth noting that the other key anti-deferral regime under U.S. law, the passive foreign investment company ("PFIC") regime, includes a look-through rule broadly similar to the Look-Through Rule discussed here. See sec. 1297(b)(2)(C). Although the Subpart F and the PFIC regimes serve somewhat different purposes, the PFIC look-

(continued...)

The Look-Through Rule recognizes this business reality and enables U.S.-based multinationals to make group funding decisions on a more flexible basis, with less distortion by U.S. tax considerations. Without this flexibility in the funding of business operations in the recent financial crisis, conditions in the credit markets would have made access to other sources of funding more difficult and unduly expensive in many cases. The continued availability of the Look-Through Rule allowed U.S.-based multinationals to use internally generated cash to fund their foreign operations in this challenging environment.

At the same time, the Look-Through Rule does nothing to weaken Subpart F as applied to its core concerns of passive income being earned by a U.S. company through low-tax subsidiaries. If a U.S. company seeks to earn passive or other Subpart F income through a low-tax subsidiary, the Look-Through Rule does nothing to defeat the application of Subpart F to this income. Even after the Look-Through Rule is applied to a particular CFC-to-CFC payment, the CFC receiving the payment remains subject to the general rules of Subpart F. Thus, if the funds are invested by that CFC passively, the return on that investment will remain subject to Subpart F. Similarly, if the funds are actually or effectively repatriated to the U.S. parent, current U.S. tax will be triggered. Only by investing the funds in active business operations does the CFC maintain U.S. tax deferral on the return on the investment of the funds.

The Look-Through Rule thus affords U.S. businesses the flexibility necessary to make key business-driven funding decisions with respect to foreign operations, without compromising the core policy concerns of Subpart F.¹¹

2. Other Avenues of Relief Inadequate

a. “Check-the-box” regulations

As the Senate Finance Committee noted in 2003, many taxpayers have been able to achieve some of the flexibility described above without the Look-Through Rule, through the use of the “check the box” entity classification regulations, which effectively disregard transactions between certain types of related foreign businesses. By way of background, it has long been axiomatic that taxpayers are entitled to select the forms in which they conduct business around the world, and thus may choose to operate through corporations, partnerships, branches, or other types of entities in various markets. Prior to the check-the-box regulations, the classification of entities for Federal tax purposes was governed by a multi-factor test that was widely viewed as cumbersome and administratively costly, but ultimately flexible in allowing taxpayers to achieve their desired classifications. The check-the-box regulations, which came into effect in 1997, generally allow taxpayers simply to elect to treat many business entities either as corporations or

through rule reflects a Congressional understanding that intercompany payments of items like dividends and interest present entirely different tax policy concerns from those presented by truly passive items like portfolio dividends and portfolio interest, and that failing to make this distinction can create undue burdens on business structuring and decision making.

¹¹ The possibility of another policy concern, relating to the reduction of foreign taxes, is considered in part II.B.3 below.

as partnerships, or, in the case of a single-member entity, to disregard the entity as separate from its owner, rather than undertaking the multi-factor analysis that was required under prior law.¹² Where an entity is “disregarded” under these regulations, it is effectively treated for tax purposes as a part of its owner. The owner is treated as directly owning all of the entity’s assets, bearing all of its liabilities, and conducting all of its activities. Accordingly, the entity’s income and expense items are regarded as those of the owner, with transactions between the entity and the owner being disregarded.

By disregarding these transactions, the check-the-box regulations in some cases mitigate the over-breadth of Subpart F described above. For example, if a CFC generates sufficient earnings from operations, and another CFC in a different country needs funds to expand its operations, a dividend of the excess funds from the first CFC to the second CFC (or from the first CFC to a CFC holding company, followed by a capital contribution to the second CFC) would trigger a Subpart F inclusion. However, if the second CFC is instead a “checked” entity wholly owned by and disregarded as separate from the first CFC (or if both CFCs are instead “checked” entities of a third CFC), then the dividends are disregarded for tax purposes, and thus no Subpart F inclusion results from the redeployment of the funds. Thus, in many circumstances, the check-the-box regulations have enabled taxpayers to make efficient cash redeployment decisions by employing fewer CFCs and more disregarded entities in their structures.

The check-the-box regulations represent only an incomplete (and accidental) solution to this problem, however. First, even for those taxpayers able to make use of strategies like the one described above, establishing the structure may require incurring considerable transaction costs and managing complex interactions of the structure with other aspects of the taxpayer’s tax compliance and planning under the foreign tax credit regime, Subpart F, and other rules. If it is considered desirable to allow U.S.-based businesses to redeploy their active foreign earnings abroad without triggering Subpart F—which the Congress apparently believes it is, based on both the 2003 Senate Finance Committee report and the Congress’s longstanding general acquiescence to the use of these well-known planning techniques—then it is surely more desirable to provide for this result directly under the statute, rather than requiring taxpayers to undertake costly “self help” measures requiring conversion of entities and other expensive measures. The check-the-box solution, even where available, imposes socially wasteful costs that are eliminated by the Look-Through Rule’s more direct approach.

In addition, many taxpayers are simply not able to use the check-the-box regulations in this manner, because they are required to conduct business through entities that are treated as *per se* corporations (i.e., are not “checkable”) under the regulations. For example, companies in certain industries, such as insurance, banking, and other regulated industries, may be required under local law to operate through corporate entities that are not “checkable” under the regulations. Taxpayers in these industries thus continue to face considerable barriers to the efficient foreign-to-foreign deployment of their active foreign earnings. In addition, certain jurisdictions, including major U.S. trading partners such as Canada and Japan, do not offer suitable non-*per-se* entities as a matter of local corporate and business law or local custom with respect to how

¹² See Treas. Reg. Sec. 301-7701-1, *et seq.*

business is conducted. Thus U.S.-based multinationals with significant operations in these countries have less flexibility with respect to funding decisions involving these operations.

b. Same-country exception

As noted above, the “same-country” rules of section 954(c)(3) afford taxpayers limited relief from the general over-breadth of Subpart F, but only when active business earnings are redeployed between subsidiaries in the same country. Furthermore, even with respect to such same-country flows, the statute and regulations have failed to keep pace with developments in international business and regulatory practices, with the result that some taxpayers may not be able to make same-country CFC-to-CFC dividends without triggering current U.S. tax under Subpart F.

For example, the European Union’s adoption of a single-licensing regulatory regime for financial institutions has allowed U.S.-based financial institutions to open branches throughout Europe under a single European CFC. This development obviously entails that such a CFC will own significant assets outside its country of organization. However, under the Subpart F regulations, this fact weighs against such a CFC in attempting to qualify for the benefits of the same-country rule in connection with a dividend to its own same-country parent, because the regulations generally require that more than half the dividend-paying CFC’s assets be business assets located in its country of incorporation.¹³ Thus, even a same-country dividend can encounter obstacles under Subpart F in certain cases involving modern business models.

c. High-tax exception

Another possible avenue of relief, the so-called high-tax exception of section 954(b)(4), also fails to allow a significant degree of flexibility in foreign-to-foreign redeployment of active foreign earnings. Under the high-tax exception, certain items that otherwise would trigger Subpart F inclusions are excluded from Subpart F, provided such items were subject to foreign tax at a rate in excess of 90 percent of the top U.S. corporate tax rate (i.e., more than 31.5 percent, based on a U.S. corporate rate of 35 percent). Although appealing in theory, the high-tax exception has substantially failed as a matter of practice, due in large part to the difficulties in establishing to the Service’s satisfaction that the foreign tax threshold is met, under computations involving highly complex interactions among foreign tax rules, U.S. tax rules, and U.S. earnings and profits calculations. Moreover, even assuming that a taxpayer can tame this complexity and uncertainty, the standard is becoming increasingly difficult to satisfy, as countries throughout the world have lowered their corporate income tax rates in recent years. Although the high-tax exception in concept might be relied upon to ensure that Subpart F does not affect “real” business operations conducted in the world’s major industrial democracies, the fact is that the vast majority of important U.S. trading partners (including, for example, Canada, China, Mexico, Germany, the United Kingdom, Australia, Italy, and Sweden) now have corporate income tax rates below 31.5 percent.

¹³ See Treas. Reg. sec. 1.954-2(b)(4)(i)(A), -2(b)(4)(iv).

3. Foreign-to-Foreign “Deflection” Not a U.S. Tax Policy Problem

In view of the general over-breadth of Subpart F with respect to related-party foreign-to-foreign payments and the limits and flaws of other avenues of relief under the statute and regulations, the Look-Through Rule serves an important purpose in allowing U.S. companies the flexibility necessary to make efficient decisions with respect to the redeployment of active foreign earnings. This has proved particularly important under economic conditions in which access to other sources of funding has been difficult. As explained above, the rule accomplishes this goal without compromising the effectiveness of Subpart F as applied to the core concern of covering truly passive income earned through low-tax subsidiaries. Some have argued, however, that another important goal of Subpart F is to prevent the “deflection” of income from high-tax foreign jurisdictions to low-tax foreign jurisdictions (also described as foreign-to-foreign “base erosion” or “stripping”). Under this view, the application of Subpart F to related-party payments that are generally deductible by the payor under foreign tax law (i.e., interest, rents, and royalties) serves an important purpose by defending the tax bases of higher-tax foreign jurisdictions.

This view is misguided, for a number of reasons. First, the world’s higher-tax countries, including the United States, are rightly concerned about defending their own tax bases from being eroded through deductible related-party payments, and most such countries have enacted robust regimes to control such base erosion. The erosion of a foreign country’s tax base is not a subject of obvious concern to U.S. tax policy makers. Indeed, to the extent that a foreign subsidiary of a U.S. company does reduce its foreign tax liability through deflection strategies, the U.S. fisc actually benefits, as reduced foreign taxes will translate into reduced foreign tax credits against residual U.S. taxes when foreign earnings are repatriated.¹⁴

It has been argued that the ability to deflect income from one foreign country to another may distort investment decisions, by rendering foreign investment more attractive on an after-tax basis than U.S. investment, thereby violating a principle described by its proponents as “capital export neutrality.” This concern does not accurately reflect how location decisions are actually made in the vast majority of situations. Location decisions with respect to customer markets are very much customer-driven. In other words, a U.S.-based multinational simply needs to have a large presence in the major EU countries, and in countries like Canada, Japan, and Australia. Once a company is there in, say, Germany, serving German customers, that company of course may engage in permissible planning to reduce the German tax liability. Again, the primary effect of this activity is to reduce German taxes, a problem to which countries like Germany understandably have devoted significant energy. The secondary effect of this activity is to increase U.S. taxes, by reducing the amount of German taxes that the United States eventually must allow as a foreign tax credit. The notion that the ability to base-erode Germany may give a U.S.-based multinational an incentive to locate activities outside the United States is much more speculative and remote.

¹⁴ This revenue benefit would of course be less of a factor under a territorial dividend exemption system, because such a system would significantly reduce the role of the foreign tax credit in mitigating the double taxation of CFC earnings. The importance of preserving the Look-Through Rule for other reasons under a territorial dividend exemption system is discussed in part VI below.

Tax considerations have at most a very limited impact on a company's basic investment location decisions, which are overwhelmingly determined by the location of customer markets and access to the necessary human capital and other resources needed to run the business. The opportunity to deflect some income from Germany into a lower-tax country—which opportunity again will be constrained, as well it should be, by specific rules of German tax law—is not likely to cause a U.S.-based multinational to set up or expand a manufacturing plant, or to open a bank branch, in Germany instead of doing so in the United States. There are simply too many other more important variables for a company to consider in making these types of decisions. Financing decisions, on the other hand, are much more prone to distortion by tax rules, because financing decisions are less tethered to concerns specific to the underlying business operation and are overwhelmingly driven by a need to minimize the cost of capital. Thus, a tax rule that interferes with a U.S.-based multinational's ability to finance its foreign operations with its active foreign earnings, based on concerns relating to foreign base erosion, not only fails to influence basic location decisions but also manages to distort financing decisions and effectively to increase the cost of capital for U.S.-based companies. This is a cost increase that American businesses can ill afford, particularly because their foreign competitors suffer no such cost increase.

In recognition of these realities, the Congress in recent years has by and large rejected capital export neutrality and deflected income as tax policy concerns, and has specifically indicated that pure foreign-to-foreign base erosion is not a phenomenon with which the U.S. tax system need be concerned. This matter was squarely at issue when Treasury and the Service issued Notice 98-11 and the related proposed regulations, which attempted to prevent foreign-to-foreign stripping in the wake of the issuance of the check-the-box regulations. Under considerable pressure from the Congress, Treasury and the Service abandoned this project, making it clear that theoretical concerns about deflected income and capital export neutrality did not justify interfering with the ability of companies to redeploy funds abroad in the most efficient manner possible. More recently, as noted above, the Senate Finance Committee implicitly endorsed this view, suggesting that the then-proposed look-through provision should be enacted in order to make more readily available strategies of the kind that Notice 98-11 and the related proposed regulations had aimed to prevent.

III. PRACTICAL IMPACT OF LOOK-THROUGH ON COMMON BUSINESS STRUCTURES

The Look-Through Rule enables U.S. companies to make efficient structuring, financing, and cash management decisions with less distortion in the form of tax considerations. It also ensures that foreign earnings of a foreign subsidiary that may be in excess of the day-to-day needs of that subsidiary will tend to be tapped by a U.S. global company to expand in other countries overseas, rather than redeploying earnings from the United States to finance overseas expansion.

For example, companies often organize themselves for business reasons on a regionalized basis, with regional holding companies owning and managing a number of different CFCs in their various regions. Often one of these CFCs will be well-established in its national market, and will be generating profits in that market that could be put to their best use by being invested in another CFC in the region, which may be in a start-up mode or may otherwise face significant funding needs. In such a case, regional management may determine that the most efficient funding method would be to have the well-established CFC pay a dividend up to the regional

holding company, which then would contribute the funds down into the CFC that needs the funds.

This kind of foreign-to-foreign funding mechanism makes sense from a non-tax perspective, but prior-law Subpart F made it overly costly and inefficient. With an extra U.S. tax cost being imposed on the use of internal foreign funds to finance the CFC start-up operation, the company could be forced to choose between either costly external borrowing or disinvestment from its U.S. business, or both, as its remaining funding options (as the U.S. parent corporation can always contribute cash down a multinational corporate chain free of U.S. tax cost). Oddly, the pre-Look-Through Subpart F rules thus not only created an impediment to efficient business decision making, but in doing so created incentives to export capital from the United States in order to finance foreign investment—clearly not a result that capital export neutrality proponents should endorse. The Look-Through Rule removes these impediments, frees companies to employ what should be an entirely uncontroversial and sensible business funding method, and in doing so reduces the distortion of funding decisions by tax considerations, which in some cases may prevent funds from leaving the United States.

Similar examples of such funding needs and decisions abound. Banks, for example, must satisfy capital requirements in each new country into which they expand, thus creating funding needs in foreign locations other than those in which excess funds have historically been generated. In any industry, a company pursuing a strategy of growth by acquisition constantly faces funding needs in foreign markets other than those in which it is currently generating profits. Across industries, the ability to direct active foreign earnings from a CFC with funds in excess of its needs to a CFC with needs in excess of its funds is a valuable tool for a company to have at its disposal, entirely apart from tax considerations. The Look-Through Rule allows these strategies to be implemented on a more tax-neutral basis.

IV. IMPORTANT COMPETITIVENESS ISSUES AT PLAY

Calibrating the U.S. tax system so that it is in tune with today's global economy is a critical issue for policymakers. U.S. companies compete across many different geographic regions, locating operations and regional headquarters where they can best serve nearby markets. They hire talented employees from many different cultures and countries. Their expansion and competitive strength depend not just on U.S. talent and operations in the United States. Rather, their vitality depends on a blend of talents and operations from around the world. Their competitors are nimble and typically are subject to residence-country tax systems that permit them to move capital and enter into efficient means of funding without incurring home-country tax on these movements. This reality is a different one from that faced by U.S. companies and the U.S. economy some 20 or 30 years ago. The Look-Through Rule helps to level the playing field for U.S. companies in today's global economy.

Most foreign-based multinationals with which U.S.-based multinationals compete do not face the sort of impediments presented by pre-Look-Through Subpart F in making funding decisions like the ones described above. Imposing U.S. tax when U.S. companies seek to expand their businesses creates a drag on U.S. companies' efforts to compete and grow in foreign markets, because they face a tax cost that generally is not suffered by their foreign-based competitors. This added tax cost can make U.S. companies flat-footed relative to their competitors in

responding to acquisition and expansion opportunities and, as described above, can even force the export of capital out of the United States in order to finance foreign opportunities. Such trade-offs and costs should not be imposed unless it is clear that something sufficiently worthwhile is being accomplished from a tax policy perspective.

U.S. policymakers should be concerned when U.S. companies face barriers to competing effectively in foreign markets with foreign-based companies that are not subject to CFC regimes as expansive as the U.S. Subpart F regime. For example, a European-based bank operating through subsidiaries throughout Europe typically can meet the capital needs of all of its growing businesses by paying dividends between foreign subsidiaries, or from one subsidiary in, say, Germany to the parent and then back down to a subsidiary in, say, the United Kingdom, without ever incurring home-country tax. The Look-Through Rule permits a U.S.-based financial institution operating in Germany and desiring to efficiently redeploy excess capital to a U.K. subsidiary to do so in a similar manner.

Nothing worthwhile is accomplished by subjecting foreign-to-foreign intercompany dividends of active earnings to current U.S. taxation, and the supposed benefit of subjecting other foreign-to-foreign intercompany redeployments of active earnings to current U.S. taxation is dubious at best and has been rejected by the Congress. The Look-Through Rule thus represents an important step in the direction of promoting the efficiency and competitiveness of the U.S. economy, and is a step that can be taken without doing harm to any important tax policy objective.

V. ANTI-ABUSE ISSUES

Shortly after the enactment of the Look-Through Rule in 2006, it became known that some tax advisors and taxpayers were considering structures that would attempt to use the rule not to accommodate foreign-to-foreign deployments of funds, but rather as a means to erode the U.S. tax base with respect to U.S.-source income and other income effectively connected with a U.S. trade or business. In response, appropriate technical corrections were quickly introduced in, and passed by, the Congress.¹⁵ Treasury and the Service also responded promptly with an anti-abuse notice.¹⁶ These measures have made it clear that, although the Look-Through Rule is designed to provide considerable flexibility in the redeployment of active foreign earnings abroad, the use of the provision to erode the U.S. tax base with respect to U.S. business activities will not be tolerated. Proponents of the Look-Through Rule supported these anti-abuse measures and remain supportive of the government's anti-abuse orientation in this regard.

Although it is doubtful that any significant further potential for abuse exists, given that U.S. base erosion has been prevented, and foreign base erosion is rightly recognized as not constituting an abuse, it is noted that the statute provides ample regulatory authority to address any unanticipated abuses that may surface in the future. Based on the Look-Through Rule's history

¹⁵ See P.L. 109-432, sec. 426(a); see also P.L. 110-172 (H.R. 4839), sec. 4(a).

¹⁶ See Notice 2007-9, sec. 7. The notice also addresses other narrow possibilities for abuse, involving effective repatriations and the use of various artifices to qualify payments other than true intercompany payments for the benefits of the provision.

to date, there is every reason to expect that any future abuses will be met with a quick and robust response, with the strong support of the many companies that are interested only in using the Look-Through Rule for its intended purposes.

VI. LOOK-THROUGH RULE WOULD REMAIN IMPORTANT UNDER A TERRITORIAL DIVIDEND EXEMPTION SYSTEM

In light of policy makers' current interest in tax reform, and the series of recent proposals to adopt a territorial dividend exemption system, it should be noted that the Look-Through Rule would be particularly important to the operation of a territorial dividend exemption system. One of the primary efficiency gains from adopting a territorial dividend exemption system would be to remove present-law distortions of cash-management decisions by eliminating (or significantly reducing) the tax drag on redeployments of foreign earnings in the United States. Under such a system, the Look-Through Rule would serve a critical function of ensuring that foreign earnings that are intended to be subject to exemption under the new system are not subjected to full U.S. tax as they are distributed up through a chain of CFCs. It would make little sense to go to the effort of adopting a territorial system only to limit the territorial approach to those active business earnings that happen to be generated at the first tier of CFCs.

For this reason, the Joint Committee staff's 2005 proposal specifically emphasized that "a special rule would provide that no subpart F inclusions would be created as a dividend moves up a chain of CFCs" in a typical corporate structure, in order to "ensure that dividends could be repatriated from lower-tier CFCs without losing the benefit of dividend exemption" and to "make it easier to redeploy CFC earnings in different jurisdictions without triggering subpart F, thus promoting neutrality as to the decision of how to dispose of CFC earnings."¹⁷ The International Tax Reform Discussion Draft released in October 2011 by Ways & Means Committee Chairman Dave Camp includes rules designed to accomplish this result.

More broadly, aside from the particular importance of the Look-Through Rule in facilitating the intended operation of a dividend exemption system, issues involving the nature and scope of Subpart F are essentially similar under worldwide deferral-based systems and territorial dividend exemption systems. Under either kind of system, special rules are typically provided to ensure current, full-rate taxation of passive or highly mobile income that otherwise might easily be shifted to tax havens, while at the same time not dragging foreign earnings from active business operations into this net. As the Joint Committee staff observed, "the desirability of various proposals that the Congress may wish to consider in this area is largely independent of the question of whether to adopt a dividend exemption system or to retain the present-law worldwide, deferral-based system."¹⁸ The efficiency and competitiveness benefits provided by the Look-Through Rule (with respect to interest, rents, and royalties, in addition to dividends) would remain important under a territorial system, as would the various conditions and

¹⁷ See Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (Jan. 27, 2005), at 190. The author worked on this report while a member of the Joint Committee staff.

¹⁸ See *supra*, at 194.

restrictions imposed under the provision and the related guidance in order to protect against the erosion of the U.S. tax base.

VII. CONCLUSION

The Look-Through Rule has the potential to remove significant obstacles to the efficient conduct of business by U.S. companies, thereby conferring considerable benefits to the U.S. economy, while compromising no important tax policy goals and presenting no significant opportunities for abuse. Unfortunately, only a fraction of the potential benefit from the Look-Through Rule has been realized thus far, due to widespread concerns about the potential expiration of the provision. These concerns have caused many companies to refrain from modifying their structures to make use of the provision, for fear that they might have to modify them again at considerable expense if the provision expires. Although these concerns have been mitigated to some extent by the recent extensions of the provision, significant uncertainty remains, preventing taxpayers from realizing the full benefit of the provision. Much more benefit would accrue to the U.S. economy through the more efficient expansion of U.S.-based businesses seeking to serve customers in markets around the world if the Congress were to make the Look-Through Rule permanent or extend it for a significant term, whether in the context of the present-law worldwide deferral-based system or under a potential territorial dividend exemption system.